IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

Nos. 75-625 and 75-626 1

CAREY J. PERRY and MARIETTA M. PERRY, *Petitioners,*

v.

UNITED STATES OF AMERICA, *Respondent*

J. DOYLE MEDDERS and CONSTANCE P. MEDDERS, *Petitioners*

v.

UNITED STATES OF AMERICA, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Petitioners pray that a Writ of Certiorari issue to review judgments of the United States Court of Appeals for the Fourth Circuit entered in these proceedings on July 29, 1975.

OPINION BELOW

The opinion of the United States Court of Appeals for the Fourth Circuit is reported at ---- F. 2d----, 36 AFTR 2d 75-5500 (the opinion is set out in full in the Appendix, 12a). The opinion of the United States District Court for the Eastern District of North Carolina is reported at 376 F. Supp. 15, 33 AFTR 2d 74-725 (E.D.N.C. 1974) (the opinion is set out in full in the Appendix 1a.)

JURISDICTION

The judgment of the United States Court of Appeals was entered July 29, 1975. Rehearing was not sought. This petition for certiorari was filed within 90 days of that date. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

I. Where property has been donated to a trust and subsequently leased back to the donor by the trustee, is it necessary that a business purpose exist for the gift of the property by the donor as well as for the leaseback of the trust property to the donor in order for the rentals paid by the donor for the use of the trust property to be deductible by him under Section 162(a)(3) [26 U.S.C. § 162(a)(3)]?

II. Where property has been donated to a trust which has an independent trustee and said independent trustee subsequently leases said property back to the donor, is the donor's need for the use of the property in connection with the operation of his business a sufficient business purpose to render the rentals paid by the donor for the use of the trust property deductible by him under Section 162 (a)(3) [26 U.S.C. § 162(a)(3)]?

III. Whether the finding of a United States District Court that the trustee in a gift and leaseback transaction was independent is a finding of fact which must be respected, under Rule 52(a) of the Federal Rules of Civil Procedure [Fed. R. Civ. P. 52(a), 28 U.S.C.], by a Circuit Court of Appeals unless such finding was "clearly erroneous?"

STATUTES AND FEDERAL RULES INVOLVED

The statutory provision involved is Section 162(a)(3), of the Internal Revenue Code of 1954 [26 U.S.C. § 162(a)(3)], and is as follows:

"Sec. 162. Trade or Business Expenses.

"(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including —

. . . .

"(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

The Federal Rule involved is Rule 52(a), Fed. R. Civ. P., 28 U.S.C. which provides:

"Rule 52. Findings by the Court.

(a) Effect. In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon, and judgment shall be entered pursuant to Rule 58; and in granting or refusing interlocutory injunctions the court shall similarly set forth the findings of fact and conclusions of law which constitute the grounds of its action. Requests for findings are not necessary for purposes of review. Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses. The findings of a master, to the extent that the court adopts them, shall be considered as the findings of the court. If an opinion or memorandum of decision is filed, it will be sufficient if the findings of fact and conclusions of

law appear therein. Findings of fact and conclusions of law are unnecessary on decisions of motions under Rules 12 or 56 or any other motion except as provided in Rule 41(b)."

STATEMENT OF THE CASE

Carey J. Perry (hereinafter referred to as "Perry") and his wife, Marietta M. Perry, and J. Doyle Medders (hereinafter referred to as "Medders") and his wife, Constance D. Medders, are individuals residing in Louisburg, North Carolina. (R. 29).* Both the Perrys and the Medders timely filed joint federal income tax returns for the calendar year 1969 with the District Director of Internal Revenue for the District of North Carolina, using the cash basis method of accounting. (R. 29, 30).

Both Perry and Medders are licensed physicians. For a number of years, including 1969 and several years prior thereto, they have practiced as partners in Louisburg, North Carolina, in a medical partnership known as the Perry-Medders Clinic (hereinafter referred to as the "Partnership"). (R. 32).

Perry and Medders purchased a lot in Louisburg, North Carolina, as tenants in common and constructed a building thereon at a cost of $36,800.65 for use in conjunction with their medical practice (hereinafter referred to as the "Property"). (R. 32). Neither Mrs. Perry nor Mrs. Medders owned any interest in the Property. (R. 32). The Partnership first occupied the Property in July, 1963; and for the years of such occupancy, through 1968, it deducted a total of $9,295.87 as depreciation expenses on said building. (R. 32).

On December 16, 1968, Medders and Mrs. Medders, as grantors, and the Citizens Bank and Trust Company of

* Such references are to pages of the "Appendix" filed with the Fourth Circuit.

Henderson, North Carolina (hereinafter referred to as the "Bank"), as trustee, entered into a trust agreement, the beneficiaries of which were the Medders' two children. (R. 33). The term of the trust created thereby was 14 years. (R. 17). On the same day Medders transferred to the trustee his undivided one-half interest in the Property. (R. 33). On the following day, December 17, 1968, the trustee, as lessor, and Medders, as lessee, entered into an agreement whereby the interest in the property previously conveyed to the trustee by Medders was leased back to Medders for a term of 14 years beginning December 17, 1968, at a rental rate of $200.00 per month. (R. 33-34).

On December 26, 1968, Perry and Mrs. Perry, as grantors, and the Bank as trustee, entered into a trust agreement, the beneficiaries of which were the Perrys' four children. (R. 33). The term of the trust created thereby was 10 years and 1 day. (R. 11). On the same day Perry transferred to the trustee his undivided one-half interest in the Property. (R. 33). On the following day, December 27, 1968, the trustee, as lessor, and Perry, as lessee, entered into an agreement whereby the interest in the Property previously conveyed to the trustee by Perry was leased back to Perry for a term of 10 years, beginning December 27, 1968, at a rental rate of $200.00 per month. (R. 33).

Except for the names of the grantors, beneficiaries, and length of term, the provisions of each of the two trust instruments are substantially identical: the grantor conveyed an undivided one-half interest in the Property (R. 9, 15); the trustee is the Bank (R. 9, 15); the trustee is authorized to hold, manage, and control and to collect and disburse the net income from the trust to or for the benefit of the respective grantors' children (R. 9, 15); upon the expiration of the specified term or upon the death of all of its grantors' children, whichever shall first occur, the trust shall terminate and its principal shall be distributed to its grantors if living, otherwise to its grantors' estates (R. 11, 17); the trustee is granted the "continuing absolute, discretionary power to deal

with any property, real or personal, held in any trust, as fully as [the grantors] might in the handling of [their] own affairs," with such powers to be exercised "independently and without prior or subsequent approval of any court or judicial authority" (R. 11, 17); and the trustee is granted all the powers set forth in North Carolina General Statute, § 32-27 (R. 11, 17). In addition, each trust agreement is irrevocable and unamendable and provides that its grantors shall have no right, title, or interest in any income accruing to the trust during its term and that its grantors shall have no incident of ownership in the assets making up the trust principal except the right to receive them upon termination of the trust. (R. 11, 17).

Except for the names of the lessees and the length of the respective terms, the provisions of each of the two lease agreements are substantially identical: a leasehold interest in an undivided one-half interest in the Property is conveyed at a rental of $200 per month (R. 21, 25); taxes and exterior repairs are to be paid by the lessor, and utilities and interior repairs are to be paid by the lessee (R. 22, 26); in the event of damage or destruction to the extent that the building cannot be repaired within 30 days, either party may terminate the lease upon written notice to the other party (R. 22, 26); and the lessor may terminate the lease and repossess the Property if the lessee defaults in any obligation under the lease and remains in default for 15 days after written notice calling his attention thereto (R. 22, 26).

During 1969 the Partnership paid a total of $4,800.00 to the Trustee as rent for the Property and claimed a rental deduction of $4,800.00 on its 1969 federal income tax return. (R. 34). The trustee-lessor reported the $4,800.00 received from the Partnership in 1969 as income for the respective trusts and claimed depreciation on said building. (R. 34).

Upon audit of the 1969 federal income tax returns of Perry and Medders, deficiencies in income tax were assessed against each of them, and each of them paid the amounts assessed and thereafter timely filed a claim for refund for

1969. (R. 30, 31). The refunds sought resulted from the determination by the Commissioner of Internal Revenue that the Partnership was not entitled to deduct $4,800.00 in rental payments made for the use of the Property during 1969. (R. 30, 31). Said claims for refund were disallowed, statutory notices of disallowance of their respective claims for refund were properly sent to Perry and Medders, and the present actions were timely instituted. The jurisdiction of the District Court was invoked under 28 U.S.C. § 1346 (a)(1).

After considering the stipulated facts, the trust agreements, the lease agreements, and legal authorities, the District Court concluded that Perry and Medders were entitled to the refunds sued for in these actions and that their consolidated motion for summary judgment should be allowed. Judgments were thereafter entered in favor of Perry and Medders, and the Respondent appealed to the United States Court of Appeals for the Fourth Circuit. (R. 49, 50). The Court of Appeals reversed the District Court and ordered judgment to be entered for the Respondent. (Appendix 19a).

REASONS WHY THE WRIT SHOULD BE GRANTED

I. THE DECISION OF THE COURT BELOW IS IN CONFLICT WITH THE DECISIONS OF OTHER COURTS OF APPEAL IN DETERMINING THE DEDUCTIBILITY OF RENTALS PAID IN GIFT AND LEASEBACK TRANSACTIONS UNDER § 162 (a)(3), INTERNAL REVENUE CODE [26 U.S.C. § 162(a)(3)].

Section 162(a)(3), Internal Revenue Code [26 U.S.C. § 162(a)(3)] provides that:

> "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including —
>
> . . . .

"(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

In its opinion in the present cases, the Fourth Circuit held that a gift of property to a trust and its subsequent leaseback must be viewed as part of an overall transaction and stated that:

"Real business purpose, therefore, must be shown to the transaction *as a whole* before any expenditures incident to elements of the transaction can be held as 'ordinary and necessary' business expenses deductible under § 162." Emphasis in Original. (Appendix 17a)

This application by the Fourth Circuit of the business purpose test to the gift as well as to the leaseback contravenes the decisions of all other Courts of Appeal that have decided the issue; and, in fact, the Fourth Circuit specifically rejected the rule laid down by the Seventh Circuit in *Skemp v. Commissioner,* 168 F. 2d 598 (7th Cir. 1948), and the Third Circuit in *Brown v. Commissioner,* 180 F. 2d 926 (3rd Cir. 1950), *cert. denied,* 340 U.S. 814 (1950).[1]

[1] See Appendix, infra, pages 16a and 18a. On page 16a the Fourth Circuit said: "We do not find *Skemp* compelling because the result in that case rests largely on a bifurcation of the overall transaction, an approach contrary to the holdings in this circuit." On page 18a it said: "*Brown* followed the bifurcated basis of decision in *Skemp* about which we have already expressed our disapproval." In this connection, the Fourth Circuit's statement, on page 18a of the Appendix, that "we do not think that our reasoning in the instant case is inconsistent with *Skemp,*" was not intended to indicate a lack of conflict in the law applied by the two Courts of Appeal; instead, the Fourth Circuit was merely indicating that employing its theory of integration instead of the *Skemp* theory of bifurcation it could have reached the same *result* as the Seventh Circuit in *Skemp* if the *Skemp* facts had been before it.

The Seventh Circuit in *Skemp v. Commissioner,* 168 F. 2d 598 (7th Cir. 1948), treated the creation of the trust and leaseback separately; and the Court stated:

"While the taxpayer voluntarily created the situation which required the payments of rent, the fact remains that the situation created did require the payments." Id. 600.

See also *Ingle Coal Corporation v. Commissioner,* 174 F. 2d 569 (7th Cir. 1949), for a reiteration of this rule by the Seventh Circuit.

The Third Circuit, in *Brown v. Commissioner,* 180 F. 2d 926 (3rd Cir. 1950), *cert. denied,* 340 U.S. 814 (1950), likewise treated the creation of the trust and leaseback separately; and the Court stated:

"There is no suggestion that the two trusts in question were not created in good faith nor that they were not valid and irrevocable. By the trust agreements the taxpayers irrevocably conveyed to an independent trustee title to the land upon which the siding was located and the coal land. The trustee then leased them back to the taxpayers upon what were found by the Tax Court to be reasonable rents and royalties. It is true that this was done pursuant to a prior understanding between the taxpayers and the prospective trustee but we do not regard this point as significant. What is controlling is that there came into the picture a new independent owner, the trustee, who was in a position to and did require the payment of the rents and royalties as a condition to the continued use and possession of the lands by the taxpayers for the purposes of their business, and wholly without regard to whether their operations resulted in taxable income." Id. 929.

In *Brooke v. United States,* 468 F. 2d 1155 (9th Cir. 1972), the Court considered and rejected the "lack of busi-

ness purpose" argument asserted by the government and stated that:

> "Neither substance nor impact denies this transfer professional or economic reality." Id. 1158.

Thus, from the foregoing it is apparent that the action taken by the Fourth Circuit in the present cases is, by its own admission, in direct conflict with the Third, Seventh, and Ninth Circuits. Further, despite what the Fourth Circuit claims the Fifth Circuit says, the Fifth Circuit has never rendered an opinion on the question of whether a gift of property and its subsequent leaseback should be viewed as part of an overall transaction for purposes of determining whether there was a business purpose.[2] Of the Fifth Circuit cases involving situations of this sort, that Court has disposed of the question in the following ways:

> In *Van Zandt v. Commissioner,* 341 F. 2d 440 (5th Cir. 1965), *cert. denied,* 382 U.S. 814 (1965), the Court stated:
>
> "[T]he ' . . . principal question is whether' the sale and leaseback ' . . . should be disregarded as a subterfuge for income tax purposes.' 188 F. 2d 531, 532. In answering that question, the Court then proceeded to tick off a number of factors which proved conclusively that there was no good business purpose for the transaction.

[2] However, in a Tax Court case, dealing with a gift-leaseback situation, which the Fifth Circuit affirmed *per curiam,* the Tax Court stated:

> "The presence or absence of business purpose in lessor-lessee transactions of the type involved herein is not in and of itself determinative. The fact that there may be a business purpose for a transaction does not necessarily mean that the transaction has economic substance for tax purposes. Similarly, the lack of a business purpose does not necessarily mean that there is no such economic substance. Compare *Van Zandt* with *Alden B. Oakes." Irvine K. Furman,* 45 T.C. 360, at 366, n. 9 (1966).

> "Whether viewed as a single or a multi-step transaction, the same is true here." Id. 443.

In other words, in *Van Zandt* the Court based its decision on a number of factors which, when applied to the facts in that case, resulted in a sham transaction, not on whether the transfers of the property involved should be treated as a single or multi-step transaction.

In *Audano v. United States,* 428 F. 2d 251 (5th Cir. 1970), the Fifth Circuit again based its decision on the fact that "the trusts established by taxpayer are a nullity for tax purposes." Id. 257. Likewise, in *W. H. Armston Co. v. Commissioner,* 188 F. 2d 531 (5th Cir. 1951), the Fifth Circuit stated:

> "We are of the opinion the Tax Court correctly held that the purported sale and lease arrangement between W. H. Armston Co., Inc., and its majority stockholder, Catherine Armston, was without substance and effect for tax purposes." Id. at 533.

Again the decision was based on the transaction as a whole being a sham, rather than requiring a business purpose for the initial sale. See also Tax Court cases which were affirmed *per curiam* by the Fifth Circuit: *Jack Wiles,* 59 T.C. 289 (1972), *aff'd* 491 F. 2d 1406 (5th Cir. 1974); *Irvine K. Furman,* 45 T.C. 360 (1966), *aff'd* 381 F. 2d 22 (5th Cir. 1967).

In *Mathews v. Commissioner,* ___ F. 2d ___, 36 AFTR 2d 75-___ (5th Cir. 1975), decided on October 1, 1975, the Fifth Circuit stated:

> " . . . it is not sufficient merely to serve up some 'business purpose' as some of the cases put it. The fact taxpayers can conjure up some reason why a businessman would enter into this sort of arrangement—tax consequences aside—does not foreclose inquiry. Rather, there must be 'economic reality.' "

And, in speaking of the gift and leaseback arrangement before it in *Mathews*, the Fifth Circuit stated:

> "Deduction of rental payments to such 'economic nullities' is not contemplated by § 162(a)(3)." Id. at ___.

Thus, once again, the Fifth Circuit has relied upon the "economic reality" of the transaction, and has not required that the initial step—the gift—be motivated by a business purpose.

It is submitted that the consistency of the other circuits is well founded, inasmuch as the rule followed by them was set forth by the Supreme Court in *Helvering v. Clifford,* 309 U.S. 331, 60 S.Ct. 554, 84 L.Ed. 788 (1940). There the Court stated:

> "Technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct as a refuge from surtaxes should not obscure the basic issue. That issue is whether the grantor *after the trust has been established* may still be treated * * * as the owner of the corpus." (Emphasis added.) 309 U.S. at 334, 60 S.Ct. at 556, 84 L.Ed. at ___.

[Although *Clifford* dealt with the question of whether the grantor of a trust might be taxed upon the trust's income, the principles enumerated therein are equally applicable, and have been applied by other courts, in determining whether a donor has retained such dominion and control over his gift to a family trust as to prevent him from deducting rents paid to such trust for his use of the donated property. *White v. Fitzpatrick,* 193 F. 2d 398, 401 (2nd Cir. 1951), *cert. denied,* 343 U.S. 928 (1952).]

The decision of the Fourth Circuit involved here is also in direct conflict with the longstanding rule of the Tax Court that in situations of the sort presented in the present cases

it is not necessary to inquire as to whether there was a business reason for making the gift but that the test of business necessity should be made by viewing the situation as it exists after the gift is made. *Jack Wiles,* 59 T.C. 289 (1974), *aff'd per curiam,* 491 F. 2d 1406 (5th Cir. 1974); *C. James Mathews,* 61 T.C. 12 (1973), *rev'd* __ F. 2d __, 36 AFTR 2d 75- ___ (5th Cir. 1975); *Sidney W. Penn,* 51 T.C. 140 (1968); *Alden B. Oakes,* 44 T.C. 524 (1965); *Albert T. Felix,* 21 T.C. 794 (1954).

Moreover, the decision of the Fourth Circuit in the present cases conflicts with decisions of the Third, Seventh, and Ninth Circuits not only in its requirement that the gift of property and its subsequent leaseback be integrated for purposes of applying the business purpose test, but also in its treatment of the significance of a trustee independent of the grantor. The significance of an independent trustee was clearly pointed out by the Court in *Brooke v. United States,* 468 F. 2d 1155, at 1157 (9th Cir. 1972), where it said that the decisions in *Brown v. Commissioner,* 180 F.2d 926 (3rd Cir. 1950), *Skemp v. Commissioner,* 168 F. 2d 598 (7th Cir. 1948), and *Van Zandt v. Commissioner,* 341 F. 2d 440 (5th Cir. 1965), "pivot on the issue of the independence of the trustee."[3]

These conflicts justify the grant of certiorari to review the judgment below. Rule 19.1(b), Rules of the Supreme Court of the United States.

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[3] The Fifth Circuit, prior to its decision in *Mathews v. Commissioner,* ____ F. 2d ____, 36 AFTR 2d 75- ____ (5th Cir. 1975), treated the independence of the trustee as being of great significance; however, in *Mathews,* the Fifth Circuit retreated to the position taken by the Fourth Circuit in the present cases. Therefore, the conflict in circuits as to the significance of the trustee's independence would now appear to have the Third, Seventh and Ninth Circuits on one side and the Fourth and Fifth Circuits on the other.

II. THE DECISION OF THE COURT BELOW RAISES SIGNIFICANT AND RECURRING PROBLEMS CONCERNING THE ADMINISTRATION AND INTERPRETATION OF THE FEDERAL INCOME TAX LAWS.

The Fourth Circuit, in the present cases, decided an important question concerning the administration and interpretation of the federal income tax laws and created confusion and a conflict of circuits relative thereto.

The widespread use of gift and leaseback arrangements throughout the United States and the position taken by the Internal Revenue Service as to the deductibility of rental payments in gift-leaseback situations gives great importance to the question decided by the Fourth Circuit and warrants its consideration by this Court.

The position of the Internal Revenue Service is well established by the fact that it has included in its list of "prime issues" the question of whether a taxpayer is entitled to deduct rental payments made to the trustees of a valid "Clifford Trust" when the payments are made for the use of property which the taxpayer had previously conveyed to the trustee and then leased back. Internal Revenue Manual, MT 1277-8, November 19, 1974.

"Prime issues" are those which, as a matter of policy, the Internal Revenue Service will not concede or compromise. Therefore, it is apparent that the question of the deductibility of rental payments in gift-leaseback arrangements will, because of the position of the Internal Revenue Service, result in recurring litigation until this Court provides appropriate guidelines.

Moreover, the Fourth Circuit has added confusion to the question by its decision in the present cases. Before this decision the Courts had followed the general rule that in

determining whether or not to allow deductions for rents paid as the result of disposition-leaseback transactions the issue was determined by the *bona fides* of it. The rule was most clearly stated in *Brooke v. United States*, 468 F. 2d 1155 (9th Cir. 1972), as follows:

> "The fundamental issue presented involves the sufficiency of the property interest transferred. The transfer of a sufficient property interest justifies the taxation of the donees and deduction of the rental payments under 26 U.S.C. § 162(a)(3) as ordinary and necessary business expenses by the donor." Id. 1157.

All cases involving disposition-leaseback situations, prior to the present case, were determined on that basis; and, if a sufficient property interest was transferred, the donee was taxed and the donor-lessee was allowed a deduction regardless of the purpose of the transfer, while if a sufficient property interest was not transferred the opposite result ensued.[4]

The Fourth Circuit by its opinion in the present cases has superimposed the additional requirement that the transfer must be for a business purpose. Such a requirement is not demanded by the law and results in the creation of great uncertainty and doubt in the disposition-leaseback area. Moreover, the rule announced by the Fourth Circuit has the effect of condemning outright and absolutely the deductibility of

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[4] The recently decided case of *Mathews v. Commissioner*, ___ F. 2d ___, 36 AFTR 2d 75-___ (5th Cir. 1975), apparently creates an exception to the consistent approach discussed in the text. In that case, the Fifth Circuit elected to treat the legal entity created by the establishment of a valid trust as a mere "flyspeck of legal title under state law . . . " Id. at ___. The Petitioners submit that the Fifth Circuit's disregard of a valid trust with a trustee independent of the settlor serves only to further confuse the entire area and strengthen the need for a review thereof by this Court.

ordinary and necessary business expenses incident to *all* gift and leaseback arrangements, a result not contemplated even by the Fifth Circuit in *Van Zandt v. Commissioner,* 341 F. 2d 440 (5th Cir. 1965), *cert. denied,* 382 U.S. 814 (1965), the case most heavily relied upon by both the government and the Fourth Circuit in the present cases. As pointed out by the United States Tax Court in *Alden B. Oakes,* 44 T.C. 524 (1965):

> " . . . *it is not necessary for us to inquire as to whether there was a business reason for making the gift. Admittedly there was none.* . . . As the Court of Appeals emphasized in *Van Zandt,* what is good business purpose 'ultimately depends on the factual evaluation of the particular case.' The facts in this case favor petitioners." Id. at 532.

Furthermore, it is an elementary and fundamental principle of federal tax law that a gift "proceeds from a 'detached and disinterested generosity,' . . . 'out of affection, respect, admiration, charity or like impulses," and not from a business motive or purpose. *Commissioner v. Duberstein,* 363 U.S. 278, 285, 80A S.Ct. 1190, 1197, 4 L.Ed. 2d 1218, ___ (1960). Thus, it is apparent that the Fourth Circuit's decision in the present cases will result in the disallowance of ordinary and necessary business expenses incident to all gift and leaseback arrangements.

The need for clarification of issues of importance in the administration of the income tax laws, particularly where a conflict between Courts of Appeal exists, constitutes a valid basis for certiorari. *Commissioner v. Duberstein,* 363 U.S. 283, 80A S.Ct. 1190, 4 L. Ed. 2d 1218 (1960). Therefore, for the foregoing reasons and because both lower courts and potential litigants urgently need the assistance and direction of this Court in a proper determination of this issue, the Petitioner's request for certiorari should be granted.

III. IN DETERMINING THAT THE TRUSTEE IN THE PRESENT CASES WAS NOT INDEPENDENT OF THE PETITIONERS, THE FOURTH CIRCUIT VIOLATED THE REQUIREMENT OF RULE 52(a) OF THE FEDERAL RULES OF CIVIL PROCEDURE [FED. R. CIV. P. RULE 52(a), 28 U.S.C.] THAT FINDINGS OF FACT SHALL NOT BE SET ASIDE UNLESS CLEARLY ERRONEOUS.

Rule 52(a), Fed. R. Civ. P., 28 U.S.C., provides that "Findings of fact shall not be set aside unless clearly erroneous. . . . " The independence of a trustee in a gift and leaseback arrangement is a question of fact. *C. James Mathews,* 61 T.C. 12, at 14 and 19 (1973), *rev'd* ___ F. 2d ___, 36 AFTR 2d 75- ___ (5th Cir. 1975); *Robert F. Zumstein,* ¶ 73,045 P-H Memo T.C. (1973). See also *Southeastern Canteen Co. v. Commissioner,* 410 F. 2d 615, at 619 (6th Cir. 1969). Furthermore, the question of whether a sale-and-leaseback is *bona fide* has been treated by the government and the Fourth Circuit as a question of fact. *American Realty Trust v. United States,* 498 F. 2d 1194 (4th Cir. 1974). See also, *Hutton v. United States,* 501 F. 2d 1055 (6th Cir. 1974), which held that whether a transaction is a "sham" for tax purposes is a finding of fact subject to Rule 52(a). In addition, this Court has held that the question of whether there has been a gift, for income tax purposes, is a question of fact, and not a question of law. *Commissioner v. Duberstein,* 363 U.S. 278, 80A S.Ct. 1190, 4 L.Ed. 2d 1218 (1960). See also *Altman v. Commissioner,* 475 F. 2d 876 (2nd Cir. 1973); *Harper v. United States,* 454 F. 2d 222 (9th Cir. 1971).

The "clearly erroneous" rule applies to appeals by the government as well as those by other litigants. *United States v. Yellow Cab Co.,* 338 U.S. 338, 70 S.Ct. 177, ___ L. Ed. ___ (1949). Furthermore, the rule applies even when documentary evidence comprises most or all of the proof or

when the case is decided on undisputed facts, as in the present cases. *Commissioner v. Duberstein*, 363 U.S. 278, 80A S.Ct. 1190, 4 L.Ed. 2d 1218 (1960) (findings based on undisputed facts); *Nalle v. First National Bank of Baltimore,* 412 F. 2d 881 (4th Cir. 1969) (documentary evidence comprised much of the proof); *Bowman v. Curt G. Joa, Inc.,* 361 F. 2d 706 (4th Cir. 1966) (District Court findings based on affidavits and briefs); *Summers v. Watkins Motor Lines,* 323 F. 2d 120 (4th Cir. 1963) (findings based on transcript); *Custom Paper Products Co. v. Atlantic Paper Box Co.,* 469 F. 2d 178 (1st Cir. 1972) (findings based solely on documentary evidence); *H. K. Porter Company, Inc. v. Goodyear Tire & Rubber Company,* 437 F. 2d 244 (6th Cir. 1971) (findings based solely on documentary evidence); *Worthen Bank & Trust Company v. The Franklin Life Insurance Company,* 370 F. 2d 97 (8th Cir. 1966) (findings based on pleadings, exhibits, answers to interrogatories and affidavits, both parties having moved for summary judgment); *Transducer Patent Company v. The Renegotiation Board,* 492 F. 2d 247 (9th Cir. 1975) (findings based on evidence "largely documentary"); *Lundgren v. Freeman,* 307 F. 2d 104 (9th Cir. 1962) (findings based on documentary evidence).

In the present cases, the District Court found that "the independence of the corporate trustee is about as firmly established as one could imagine." Appendix 8a. Therefore, the Fourth Circuit, in its consideration of the cases on appeal, was bound by Rule 52(a) to respect the District Court's finding that the corporate trustee was independent unless such finding was "clearly erroneous." *American Realty Trust v. United States,* 498 F. 2d 1194 (4th Cir. 1974); *Bowman v. Curt G. Joa,* Inc., 361 F. 2d 706 (4th Cir. 1966); *Summers v. Watkins Motor Lines,* 323 F. 2d 120 (4th Cir. 1963). Notwithstanding the requirements of Rule 52(a), however, the Fourth Circuit made its own findings that the independence of the corporate trustee in the present cases

was "largely illusory." (Appendix 16a). The rationale for this finding was as follows:

> "The bank had virtually no function save to hold legal title and to receive and remit the rental payments arranged by the settlors at the time the trusts were created. The terms and conditions of the leases were fixed before the trusts were created and the durations of the leases were identical to those of the trusts. There was literally no area in which the broad powers of management vested in the bank as trustee could operate." Appendix 16a.

The Petitioners submit that the District Court's findings as to the independence of the trustee were amply supported by the evidence in the cases, and were therefore not "clearly erroneous." On the other hand, the conclusion of the Fourth Circuit is based on no evidence at all, but rather solely on speculation as to how the corporate trustee would react to a breach of the lease agreement by the Petitioners. The Petitioners submit that the action of the Fourth Circuit is patently erroneous. As the District Court stated:

> "It may be true, as the government seems to argue, that in reality the trustee here is going to respect the wishes of the taxpayers, but the legal effect of the transaction into which they have entered must be judged by the instruments as executed and not on speculation." Appendix 8a.

See also *Skemp v. Commissioner,* 168 F. 2d. 598, 599 (7th Cir. 1948).

The Petitioners respectfully submit that the Fourth Circuit, by reversing the District Court's findings as to the trustee's independence and thereby violating the requirements of Rule 52(a), has rendered a decision which "has so far departed from the accepted and usual course of judicial proceedings . . .

as to call for an exercise of this court's power of supervision." Rule 19.1(b), Rules of the Supreme Court of the United States. The Petitioners further submit that this Court, in the exercise of its responsibility for the proper functioning of the federal judiciary, should grant the writ of certiorari in the present cases in order to ensure that the function of District Courts in passing on disputed questions of fact is respected.

CONCLUSION

For the foregoing reasons, this Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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Attorneys for Petitioners

APPENDIX

APPENDIX

(1) Opinion of the District Court

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT
OF NORTH CAROLINA
RALEIGH DIVISION

CAREY J. PERRY and
MARIETTA M. PERRY,

Plaintiffs

VS. CIVIL NO. 4157

UNITED STATES OF AMERICA,

Defendant

J. DOYLE MEDDERS and
CONSTANCE D. MEDDERS,

Plaintiffs

VS. CIVIL NO. 4158

UNITED STATES OF AMERICA,

Defendant

MEMORANDUM OF DECISION

In these two tax refund suits which have been consolidated and submitted to the court on cross motions for summary judgment based on an agreed statement of facts, the plain-

tiffs, Carey J. Perry and J. Doyle Medders, two physicians who practice as a partnership, seek to recover the amounts assessed and collected from them (by Perry, $1,088.92, and by Medders, $925.56) resulting from a determination by the Commissioner of Internal Revenue that the taxpayers were not entitled to deductions on their 1969 income tax returns of $4,800.00 paid by the medical partnership for the rental of an office building in Louisburg, North Carolina. Claims for refunds having been timely filed and denied, these actions were timely instituted on January 23, 1973. The court has jurisdiction of the parties and subject matter by virtue of Section 1346(a)(1), Title 28, United States Code.

The case has been submitted to the court on a joint stipulation of facts and one affidavit submitted by defendant. The facts may be briefly summarized as follows:

Prior to December, 1968, the male plaintiffs owned as tenants in common and occupied an office building in Louisburg, North Carolina, in which they conducted their medical practice. Their wives owned no interest in the property. By separate trust agreements executed in December, 1968, the plaintiffs transferred the office building to the Citizens Bank & Trust Company of Henderson, North Carolina, as trustee with their children as primary beneficiaries, and pursuant to a prearranged plan between the doctors and the trustee the office building was leased back to the doctors in two separate lease agreements for a total rental of $400 per month. The doctors continued their practice in the building as they had done since its completion in 1963. There are no other occupants or tenants of the building. The partnership paid to the trustee as lessor for the year 1969 $4,800 as rent and deducted a total of $4,800 on the partnership income tax return for that year as rental payments. The bank as trustee-lessor reported the $4,800 on its fiduciary income tax return for 1969 and claimed depreciation on the building.

Except for the names of the grantors, beneficiaries and length of term (ten years and one day in the Perry trust and fourteen years in the Medders trust), the provisions of the two trust instruments were virtually identical. Each conveyed a one-half undivided interest in the office building which the trustee was authorized to hold, manage and control and to collect and disburse the net income therefrom to or for the benefit of the grantors' children. Each contained a provision that:

> "Upon the expiration of [ten years and one day—Perry; fourteen years—Medders] from the date hereof or upon the death of the Grantor's said children, [naming them], whichever shall first occur, the trust hereunder shall terminate and the principal thereof shall be distributed to the Grantor if living, otherwise to the Grantor's estate."

The power and authority granted the trustee in each trust agreement was couched in this language:

> "I hereby grant to the Trustee of each trust established hereunder the continuing absolute, discretionary power to deal with any property, real or personal, held in any trust, as freely as I might in the handling of my own affairs. Such power may be exercised independently and without prior or subsequent approval of any court or judicial authority, and no person dealing with the Trustee shall be required to inquire into the propriety of any of their actions. Without in any way limiting the generality of the foregoing and subject to North Carolina General Statute, Section 32-26, I hereby grant to my Trustee hereunder all the powers set forth in North Carolina General Statute, Section 32-27, and these powers are hereby incorporated by reference and made a part of this instrument and such powers are

intended to be in addition to and not in substitution of the powers conferred by law."[1]

Article IV of each of the trust agreements reads as follows:

"This Agreement is hereby declared to be irrevocable and the Grantor shall have no right to alter or amend same in any respect or particular. The Grantor shall have no right, title or interest in any of the income which shall accrue during the term of the trust, and shall have no incident of ownership in the principal except the right to receive such principal upon the termination of the trust as expressly provided herein."

---

[1] G.S. 32-26 permits incorporation by reference in a trust agreement of any or all of the provisions of G.S. 32-27 with the same effect as if the statutory language were set forth verbatim in the instrument. G.S. 32-27 enumerates thirty-one separate powers which may be incorporated by reference in a trust agreement as provided in G.S. 32-26, the effect of which is to vest the trustee with virtually every right, privilege and incident of ownership enjoyed by the grantor in the instrument. With respect to the management of real property the trustee is given authority in G.S. 32-27(8)e. "to lease any such property or part thereof to commence at the present or in the future, upon such terms and conditions, including options to renew or purchase, and for such period or periods of time as the fiduciary deems advisable although such period or periods may extend beyond the duration of the trust or the administration of the estate involved; h. to modify, renew or extend leases; i. to employ agents to rent and collect rents; . . . k. to erect, repair or renovate any building or other improvement on such property, and to remove or demolish any building or other improvement in whole or in part; and 1. to deal with any such property and every part thereof in all other ways and for such other purposes or considerations as it would be lawful for any person owning the same to deal with such property either in the same or in different ways from those specified elsewhere in this subdivision (8)."

With the exception of the names of the lessees and the length of the term (ten years in the lease back to Dr. Perry and fourteen years in the lease back to Dr. Medders), the provisions of the two lease agreements were also virtually identical. Each conveyed a leasehold interest in a one-half undivided interest in the office building for a rental of $200 per month with taxes to be paid by the bank as trustee, utilities to be paid by the tenant, exterior repairs to be paid by the trustee and interior repairs by the tenant; in the event of damage or destruction by fire to the extent the building cannot be repaired within thirty days, either party may terminate the lease upon written notice to the other party; and the trustee as landlord reserves the right to declare the lease terminated and cancelled if the lessee defaults in any of his obligations under the lease and remains in default for fifteen days after written notice calling his attention thereto.

In resisting the claims of these taxpayers for refunds the government has not contended that the two trust agreements are not valid "Clifford trusts" under Sections 671-678 of the Internal Revenue Code of 1954. Nor does the government contend that the amount paid as rent under the lease agreements, a total of $4,800 per year, is not reasonable. Rather, it is the government's position that the rent payments do not qualify as deductible business expenses because "(1) the lease transactions were sham transactions and should be disregarded for purposes of taxation, and (2) alternatively, the taxpayers retained an equity in the property." The court rejects each of these arguments and rules in favor of the taxpayers.

Section 162 of the Internal Revenue Code of 1954 (26 U.S.C.) reads in pertinent part as follows:

"*Section 162. Trade or Business Expenses*

"(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or

incurred during the taxable year in carrying on any trade or business, including —

* * *

"(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

The cases which have dealt with this statute in conjunction with transfer and lease back arrangements under otherwise valid Clifford trusts have reached seemingly divergent results, but a close reading of these cases reveal that each one has been decided on its own peculiar facts and that some harmonization is possible. The government relies strongly on *Van Zandt v. Commissioner,* 341 F. 2d 440 (5th Cir. 1965), in which a physician who conveyed his office building and equipment to himself as trustee for his children in an irrevocable trust for ten years and two months was held not entitled to deduct rental payments made pursuant to a lease back of the building and equipment to himself for use in his medical practice. The court reasoned that notwithstanding this was a valid trust, there was no real business purpose served by the transaction. The court obviously felt that the control retained by the grantor was such as to render the whole transaction a sham. The decision was careful, however, not to condemn "outright and absolutely all transfers of property . . . as between a taxpayer and closely related parties . . . which result in economic benefit and income tax advantages." *Id.* p. 443.

The taxpayers here rely just as strongly on *Skemp v. Commissioner,* 168 F. 2d 598 (7th Cir. 1948). In that case a physician created an irrevocable trust for the benefit of his wife and children by conveying his office building into a corporate trust company with which he was in no way connected as stockholder or otherwise for a period of twenty

years subject to earlier termination should the physician and his wife both die. Upon the termination of the trust the property was to be distributed to the taxpayer's children, and he retained no significant control over the trust except the right to rent all or a part of the building "at a rental to be determined by the trustee." Simultaneously the taxpayer entered into a lease with the trustee for a period of ten years at a monthly rental of $500 which the Commissioner did not contend was unreasonable. In holding the rent payments deductible to the taxpayer the Seventh Circuit said:

"Payments of rent are thus specifically included in the statute as deduction. Unless we are to impute to the trustee a violation of its fiduciary duty, the taxpayer is 'required' to pay these monthly sums—they are a legal and collectible obligation. Without further imputing such violation to the trustee, we cannot say that the taxpayer must not pay them 'as a condition to the continued use or possession'. There is no basis in the facts for such imputations, and the tax court's conclusion that the payments were gratuities is mistaken." *Id.,* p. 599.

Rejecting the Commissioner's argument that the payments as rent were not required because the taxpayer had voluntarily entered into the transaction, the court went on to say:

"While the taxpayer voluntarily created the situation which required the payments of rent, the fact remains that the situation created did require the payments. In this case we have a valid, irrevocable trust, wholly divesting the taxpayer of any interest in the trust property, and an agreement by the taxpayer to pay the trustee a reasonable rental under a valid lease . . . The trustee was duty bound to exact rent of the taxpayer and the taxpayer was legally bound to pay it, just as much as if the taxpayer had moved across the street into the property of a third party. No one doubts that he would have had to pay rent then, and would have been entitled

to deduct it even though he had voluntarily created that situation."

In the absence of Fourth Circuit decisional guidance this court is constrained to hold that the facts of this case bring it more nearly within the reasoning of *Skemp* than *Van Zandt*. It is true, as the government suggests, that the transactions here were entered into by prearrangement, but as a practical matter this will always be so, and a prior agreement to lease standing alone has been held not to render rental payments non-deductible. *Brown v. Commissioner,* 180 F. 2d 926 (3rd Cir. 1950); *Alden B. Oakes,* 44 T.C. 524 (1965); *Albert T. Felix,* 21 T.C. 794 (1954).

Unlike the situation in *Van Zandt* where the grantor himself undertook to act as trustee, in this case the independence of the corporate trustee is about as firmly established as one could imagine. It may be true, as the government seems to argue, that in reality the trustee here is going to respect the wishes of the taxpayers, but the legal effect of the transaction into which they have entered must be judged by the instruments as executed and not on speculation. In addition to the language in the trust agreements themselves the statutory language incorporated therein by reference is about as broad as could be devised.[2]

A secondary argument advanced by the government is that the taxpayers retained an equity in the property involved and are therefore precluded under the terms of Section 162

[2] See Footnote 1. It is understood that the lease agreements in this case are not recorded, and under North Carolina law they would not be binding on a good faith purchaser for value for a period longer than three years from the dates on which they were executed which three-year period has now expired. Thus the trustee, if it chose to do so, could sell the office building to a good faith purchaser leaving the taxpayers with only a right of action against the trustee for breach of their lease agreements. Admittedly an extremely unlikely eventuality, it is nevertheless a possibility under the trust instruments as drawn.

from deducting as business expenses the rental payments made. This argument must also be rejected. This court agrees with the Tax Court in its recent opinion in *C. James Matthews* 61 T.C. ____ (decided October 3, 1973), where it is said:

> "We are therefore of the view that Section 162 (a)(3) should not be read to cause rental payments to become non-deductible merely by virtue of a lessee's property rights in an asset, which rights are not derived from the lessor or under the lease, and which will become possessory only after the lease expires."

Traditionally the words "in which he has no equity" as used in this statute have been construed to preclude a business expense deduction for payments made by a mortgagor or conditional vendee to acquire property as distinguished from payments made for the use of the property. In this case the rental payments being made by the taxpayers do not enlarge their ownership but are simply for the use of the property during the term of the trust. See *Duffy v. United States,* 343 F. Supp. 4, 8 (S.D. Ohio 1972), *reversed on other grounds,* ___ F. 2d ___ (6th Cir., Nov. 16, 1973).

The conclusion is that the taxpayers are entitled to the refunds sued for in these actions and that their motions for summary judgment must be allowed. In conformity with the stipulations of record counsel will ascertain within sixty days from this date the exact amounts of the refunds together with interest according to law on the basis of a recomputation by the Internal Revenue Service agreed to by all parties. In the event of the failure of the parties to agree the matter will be resubmitted to the court for resolution on the basis of a supplemental stipulation of facts or upon such additional data as may be required, and judgment will be entered accordingly.

Dated: January 22, 1974.

/s/ F. T. DUPREE, JR.
F. T. Dupree, Jr.

United States District Judge

(2) Judgments of the District Court

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT
OF NORTH CAROLINA
RALEIGH DIVISION

CIVIL No. 4158

J. DOYLE MEDDERS and
CONSTANCE D. MEDDERS,

Plaintiffs

JUDGMENT

v.

UNITED STATES OF AMERICA,

Defendant

THIS CAUSE COMING ON TO BE HEARD and having been heard by the Court, and findings of fact and conclusions of law made thereon, it is hereby

ORDERED, ADJUDGED, and DECREED that the Plaintiffs, J. Doyle Medders and Constance D. Medders, have judgment against the Defendant for refund of federal income taxes in the principal amount of $925.45 for their taxable year ended December 31, 1969, plus statutory interest thereon as provided by law, and it is further

ORDERED, ADJUDGED, and DECREED that the costs of this action be taxed to the Defendant.

This 18 day of April, 1974.

/s/ F. T. DUPREE, Jr.
F. T. Dupree, Jr.

United States District Court

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT
OF NORTH CAROLINA
RALEIGH DIVISION

CIVIL NO. 4157

CAREY J. PERRY and
MARIETTA M. PERRY,

Plaintiffs

JUDGMENT

v.

UNITED STATES OF AMERICA,

Defendant

THIS CAUSE COMING ON TO BE HEARD and having been heard by the Court, and findings of fact and conclusions of law made thereon, it is hereby

ORDERED, ADJUDGED, and DECREED that the Plaintiffs, Carey J. Perry, and Marietta M. Perry, have judgment against the Defendant for refund of federal income taxes in the principal amount of $987.89 for their taxable year ended December 31, 1969, plus statutory interest thereon as provided by law, and it is further

ORDERED, ADJUDGED, and DECREED that the costs of this action be taxed to the Defendant.

This the 18th day of April, 1974.

/s/ F. T. DUPREE, Jr.
F. T. Dupree, Jr.

United States District Court

(3) Opinion of the Court of Appeals

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 74-1852

Carey J. Perry and Marietta M. Perry, Appellees,

v.

United States of America, Appellant.

No. 74-1853

J. Doyle Medders and Constance D. Medders, Appellees,

v.

United States of America, Appellant.

Appeals from the United States District Court for the Eastern District of North Carolina, at Raleigh. F. T. Dupree, Jr., District Judge.

Argued March 5, 1975 Decided July 29, 1975

Before WINTER, CRAVEN and RUSSELL, Circuit Judges
WINTER, Circuit Judge:

In tax refund suits the district court gave judgment to two physicians for taxes assessed by the government and paid by them resulting from the government's disallowance of their 1969 rental payments for their medical offices. The rental payments were held to be "ordinary and necessary" business expenses deductible under § 162 of the Internal Revenue Code of 1954. 26 U.S.C. § 162(a)(3). The medical offices had been previously owned by taxpayers but leased back after they conveyed title to Clifford trusts for the benefit of their children. Because we conclude that the rental payments were not ordinary and necessary business expenses, we reverse.

I.

The facts, which were stipulated in most part, are set forth at length in the district court's memorandum of decision,[1] and they need not be repeated at length. The salient ones are that taxpayers (whose wives are joined because they filed joint income tax returns with their husbands) practice medicine in a medical partnership known as Perry-Medders Clinic. They acquired land as tenants in common and constructed on it an office building suitable for their practice. The building was completed in 1963. Ever since, it has been used for their medical practice, and taxpayers have been its sole occupants.

In 1968, each taxpayer established a Clifford trust for the benefit of his children,[2] naming the same bank as corporate trustee. Each taxpayer then conveyed his half interest in the property to the trust of which he was the settlor; it was the sole asset of his trust. The trusts were known as the Perry trust and the Medders trust. The term of the Perry trust was ten years; the term of the Medders trust was fourteen years. The provisions of the trust instruments were otherwise identical. Under each, the trustee had broad administrative powers, and remainder interests were reserved

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[1] The district court's opinion is not officially reported. It is unofficially reported at 33 AFTR 725 (1974).

[2] The parties agree that the trusts created by the taxpayers are valid under the "Clifford" sections of the Internal Revenue Code of 1954, 26 U.S.C. §§ 671-678. Congress has indicated, however, and we agree, that the issue before us must be decided without reference to the validity of the trust under the Clifford sections. See S. Rep. No. 1622, 83d Cong., 2d Sess. 365 (1954):

> The effect of this provision is to insure that taxability of Clifford type trusts shall be governed solely by this subpart . . . . *This subpart also has no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement.* (Emphasis added.)

in the settlors upon expiration of the trust, or the death of the beneficiaries, whichever should first occur.

Prior to the actual conveyance of the *res* to the trustee, a leaseback of the medical office building was arranged, and the trust instruments and leases were executed contemporaneously. Each taxpayer leased a one-half interest in the building for the same term as the term of the trust he created. Each agreed to pay a monthly rent of $200, to pay personal property taxes on equipment in the building, and to undertake interior maintenance and repairs.

II.

In concluding that the rent payments were ordinary and necessary business expenses and that taxpayers were entitled to recover the additional 1969 income taxes assessed by reason of their disallowance, the district court recognized an apparent divergence between the views expressed in *Van Zandt v. Commissioner,* 341 F. 2d 440 (5 Cir. 1965), which held that rental payments under a similar Clifford trust and leaseback arrangement were not deductible as ordinary and necessary business expenses, and *Skemp v. Commissioner,* 168 F. 2d 598 (7 Cir. 1944), which held them deductible. It followed *Skemp,* where the trustee was a bank, and distinguished *Van Zandt* on the basis that in *Van Zandt* the trustee of the Clifford trust was the settlor, who thus retained control over the trust assets. *Skemp* controlled, it was concluded, because in the instant cases a truly independent corporate trustee was named. Indeed, the district court even suggested in a footnote that the corporate trustee, by selling the property to a good-faith purchaser, had a legal right to avoid the prearranged leases because they were not recorded and under North Carolina law were not binding after the expiration of three years from the date of their execution. Although a factor probably leading to the result in *Skemp* was that, there, the settlor retained no reversionary interest in the *res* of the trust upon its termination,

while here, the property would revert to the settlors upon termination of the trusts, the district court ruled the factor irrelevant since taxpayers paid rent to use the property and not to enlarge their ownership.

We disagree. We think our cases are indistinguishable from *Van Zandt,* that the latter was correctly decided, and that it should be applied here. In *Van Zandt,* the trust and leaseback transaction was, in its essential elements, identical to the instant transactions. Dr. Van Zandt owned the office building in which he conducted his surgical practice. He conveyed it and his equipment to a trustee (himself) for his children for a term of ten years and two months, and simultaneously, as trustee, leased the property and equipment to himself as an individual. Upon the termination of the trust, its assets reverted to Dr. Van Zandt.

Prior to the transactions, Dr. Van Zandt was under no obligation to pay rent, and the court could find no business purpose in establishing the trust and in the leaseback of the *res* to justify the diversion of a part of Dr. Van Zandt's income to his children. The court was careful to point out that diversion of income was neither an illegal nor an immoral objective, but concluded that the "*obligation* to pay rent resulted not as an ordinary and necessary incident in the conduct of the business, but was in fact created solely for the purpose of permitting a division of the taxpayer's income tax." (Emphasis in original.) Accordingly, it concluded that "[r]ent paid to discharge an obligation so created is itself not an ordinary and necessary business expense." 341 F. 2d at 443.

A careful reading of the opinion in *Van Zandt* does not indicate that the fact that Dr. Van Zandt named himself as trustee was crucial to the decision of the case. Rather, the primary basis of decision was the fact that "the trustee had nothing whatever to do in the management of the trusts, except to receive the income which had been predetermined. The whole principal amount of the trust was irrevocably com-

mitted to the possession of the grantor the moment the trust was created." 341 F. 2d at 443. Viewing the creation of the trust and the leaseback as a single transaction, the court concluded that the "*obligation* to pay rent" was not an *ordinary* and *necessary* incident to a transaction with a *real* business purpose; hence, the deduction for rental payments under § 162 was disallowed.

In the instant case, notwithstanding that the bank was named as trustee, the same is true. The bank had virtually no function save to hold legal title and to receive and remit the rental payments arranged by the settlors at the time the trusts were created. The terms and conditions of the leases were fixed before the trusts were created and the durations of the leases were identical to those of the trusts. There was literally no area in which the broad powers of management vested in the bank as trustee could operate. Its "independence" from the settlors was largely illusory, and the illusion is given no substance by the mere legal possibility that the bank could breach the leases and actively manage the proceeds of sale. We think, therefore, that the taxpayers' obligations to pay rent to the bank did not result from a transaction with a real business purpose. We conclude to apply and follow *Van Zandt*.[3]

We do not find *Skemp* compelling because the result in that case rests largely on a bifurcation of the overall transaction, an approach contrary to holdings in this circuit. In

[3] We are reinforced in our views by the decisions in *Wiles v. Commissioner*, ___ F.2d ___ (5 Cir. 1974) (per curiam) aff'g, 59 T.C. 289 (1972); *Audano v. United States*, 428 F. 2d 251 (5 Cir. 1970); *Chace v. United States*, 422 F. 2d 292 (5 Cir. 1970) (per curiam) aff'g 303 F.S. 513 (M.D. Fla. 1969); *Furman v. Commissioner*, 381 F. 2d 22 (5 Cir. 1967) (per curiam) aff'g 45 T.C. 360 (1966). See also *Brooke v. United States*, 468 F. 2d 1155, 1159 (9 Cir. 1972) (Ely, J., dissenting); *Finley v. Commissioner*, 255 F. 2d 128 (10 Cir. 1958); *White v. Fitzpatrick*, 193 F. 2d 398 (2 Cir. 1951), cert. denied 343 U.S. 928 (1952).

Skemp, the court viewed creation of the trust and the leaseback separately and not as part of an overall transaction. Thus, it held that while there was no business purpose for creation of the trust, a business purpose arose once the trust was created because the taxpayer was then required to pay rent if he wished to continue to occupy the premises. 168 F. 2d at 599-600. In our circuit we customarily view a multistep transaction by its overall effect and not simply by scrutiny of mutually dependent steps. See, e.g., *DeTreville v. United States*, 445 F. 2d 1306 (4 Cir. 1971); *J. M. Turner & Co. v. Commissioner*, 247 F. 2d 370 (4 Cir. 1957); *Starr v. Commissioner*, 82 F. 2d 964 (4 Cir. 1936), cert. denied, 298 U.S. 680 (1936). Real business purpose, therefore, must be shown to the transaction *as a whole* before any expenditures incident to elements of the transaction can be held "ordinary and necessary" business expenses deductible under § 162.

As the *Van Zandt* court pointed out, however, under the overall approach favored in both this circuit and the Fifth Circuit, the *Skemp* result might still be reached. In *Skemp*, more property was conveyed to the trustee than was leased back to the doctor for his use and "there may have been a proper business purpose of conveying the property to the trustees for management and payment of income to the beneficiaries, since the whole income did not come from the grantor." *Van Zandt v. Commissioner*, 345 F. 2d at 442. Certainly the trustee performed functions other than being solely the conduit by which part of the doctor's earnings were diverted to his wife and children. Moreover, the grantor divested himself entirely of any interest in the property which he conveyed to the trustee because he retained no reversionary interest in the *res* upon termination of the trusts. In sum, the trustee was not obliged to administer the trust for the ultimate benefit of the grantor. Thus, rent payments by the grantor to the trustee might be part of a transaction with a real business purpose, so that a § 162 deduction would be possible. Con-

sequently we do not think that our reasoning in the instant case is inconsistent with *Skemp*.

Nor are we persuaded by the holdings in *Brooke v. United States,* supra, or *Brown v. Commissioner,* 180 F. 2d 926 (3 Cir.), cert. denied, 340 U.S. 814 (1950), both of which are cited by taxpayers. *Brooke* was decided by a divided court. While we find Judge Ely's dissent persuasive, factually there are dissimilarities between *Brooke* and the instant case which serve to distinguish the two results. Dr. Brooke did not arrange a future long-term diversion of his expected income to his children. The conveyance to taxpayer's minor children was absolute, without remainder, and not in trust. Taxpayer thereafter had himself judicially appointed as guardian for his children. There was no formal leaseback of the premises; the tenancy was from month to month. The guardianship was under continuing judicial supervision, and it and the tenancy could be terminated at any time. The property had other tenants as well as Dr. Brooke.

Unlike the case at bar, there was thus absent the relative certainty that taxpayer's income would be diverted to his children in the amounts fixed by him since the guardianship court could direct termination of the month-to-month tenancy and negotiation of a new tenancy for Dr. Brooke's continued occupancy of the property. Moreover, Dr. Brooke's rental payments were (a) only part of the total rents issuing from the property, (b) which he had irrevocably conveyed away —two indices of a transaction having a real business purpose sufficient to deem his payment of rent an ordinary and necessary business expense for him.

Brown followed the bifurcated basis of decision in *Skemp* about which we have already expressed our disapproval. It, too, was a split decision, and it, too, is at least partially factually distinguishable from the cases at bar. Taxpayers conveyed coal lands and land containing a railroad siding to their attorney, as trustee, for the benefit of their children until the eldest, age three, reached twenty-five. Taxpayers did not

reserve any reversionary interest. Taxpayers leased the railroad siding for ten years and the right to mine coal for five years; they had paid charges for the use of the siding for some time before they acquired the property on which it was located.

It is manifest that taxpayers did not control the diversion of income to their children throughout the entire terms of the trusts. Moreover, as to rent for use of the siding, the payments were a continuation of the historic pattern of use of the property to produce income, and, as to the royalty for coal mined, payment for property taken. Thus, both may be considered incidents to a transaction with economic reality and business purpose, so that payment by taxpayers was deductible under § 162.

For the reasons we have advanced, the judgments of the district court are

Reversed.

(4) Judgments of the Court of Appeals

JUDGMENT
UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 74-1852

Carey J. Perry and Marietta M. Perry, Appellee,

versus

United States of America, Appellant.

APPEAL FROM the United States District Court for the Eastern District of North Carolina.

THIS CAUSE came on to be heard on the record from the United States District Court for the Eastern District of North Carolina, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now here ordered and adjudged by this Court that the judgment of the said District Court appealed from, in this cause, be, and the same is hereby, reversed.

/s/ WILLIAM K. SLATE, II, *Clerk*

Filed: July 29, 1975.

JUDGMENT
UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 74-1853

J. Doyle Medders and Constance D. Medders, Appellee,

versus

United States of America, Appellant.

APPEAL FROM the United States District Court for the Eastern District of North Carolina.

THIS CAUSE came on to be heard on the record from the United States District Court for the Eastern District of North Carolina, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now here ordered and adjudged by this Court that the judgment of the said District Court appealed from, in this cause, be, and the same is hereby, reversed.

/s/ WILLIAM K. SLATE, II, *Clerk*

Filed: July 29, 1975.

B N A

No. 75-625

In the Supreme Court of the United States

OCTOBER TERM, 1975

CAREY J. PERRY, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

ROBERT H. BORK,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

In the Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-625

CAREY J. PERRY, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The question presented in this income tax case is whether the court of appeals correctly held that purported rental payments, made by petitioners pursuant to a gift and leaseback arrangement, were not deductible as ordinary and necessary business expenses under Section 162(a)(3) of the Internal Revenue Code of 1954.

The pertinent facts are as follows: Petitioners[1] are physicians. In December, 1968, they transferred their interests in the office building in which they conducted their medical practices to short-term trusts for the benefit of their children. The trust created by Dr. Perry was to last ten years, and the trust created by Dr. Medders was to last fourteen years; the trustee under both trusts was a local bank (Pet. App. 2a, 13a). The corpus of each of the trusts was to revert to the petitioner-settlors at the end of the trust term (Pet. App. 13a-14a).

Prior to the actual transfer of the property to the trusts, a leaseback arrangement was agreed upon with the prospective trustee pursuant to which each petitioner leased back his respective interest in the office building for the entire term of the trust he had creased, at a concededly fair rental (Pet. App. 2a, 5a, 14a). Petitioners were the sole occupants of the office building and continued to use it without interruption (Pet. App. 2a). Although the trustee was nominally given broad management powers, it in fact held only legal title to the building (Pet. App. 16a).

The district court upheld petitioners' claimed business expense deduction for the rent under Section 162(a)(3) of the Code (Pet. App. 1a-9a). The court of appeals reversed. It held that the gift and leaseback transaction as a whole had no real business

[1] "Petitioners" refers to Carey J. Perry and J. Doyle Medders. Marietta M. Perry and Constance D. Medders are parties solely because they filed joint returns with their husbands for the taxable year at issue.

purpose, so that the claimed rental deduction was not allowable (Pet. App. 12a-19a).

In holding that petitioners' payments to their trusts, which existed primarily as a vehicle for diverting income to their children, could not form the basis of a business expense deduction, the court of appeals followed the Fifth Circuit's well-reasoned decision in *Van Zandt* v. *Commissioner*, 341 F.2d 440, certiorari denied, 382 U.S. 814, which was recently reaffirmed by that court in *Mathews* v. *Commissioner*, No. 74-2084, decided October 1, 1975. *Skemp* v. *Commissioner*, 168 F.2d 598 (C.A. 7) (Pet. 9) is not to the contrary. As the court of appeals noted (Pet. App. 17a), the result in *Skemp* turned on the fact that more property was conveyed to the trustee than was leased back to the doctor for his use. Under these circumstances, the trustee was not solely a conduit for the diversion of the doctor's earnings to his wife and children. See also *Van Zandt* v. *Commissioner*, *supra*, 341 F.2d at 442. Moreover, in *Skemp*, the grantor retained no reversionary interest in the property upon the termination of the trusts.

Similarly, *Brooke* v. *United States*, 468 F.2d 1155 (C.A. 9) and *Brown* v. *Commissioner*, 180 F.2d 926 (C.A. 3), certiorari denied, 340 U.S. 814, relied upon by petitioner (Pet. 9), do not conflict with the decision below. Unlike this case, *Brooke* involved an absolute, outright conveyance to the taxpayer's children, and not a trust for a term of years. *Brown* involved the transfer by the taxpayer of coal-produc-

ing property and a railroad siding to a trust for the transferors' children for twenty-two years. However, unlike the situation in this case where the terms of the lease and the trust were co-extensive,[2] the taxpayer in *Brown* leased the coal land for five years and the railroad siding for ten years. Under these circumstances, the court in that case treated the trust and leaseback as separate transactions. Finally, unlike this case where the trust corpus was to revert to petitioners upon the termination of the trusts, the taxpayer in *Brown* retained no reversionary interest in the trust property.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

DECEMBER 1975.

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[2] As the court stated in *Van Zandt* v. *Commissioner, supra,* 341 F.2d at 444:

> * * * factors such as the short term of the trust, reversion to the settlors, predetermination of the right to possession of the property, and the like * * * bear heavily on the element of business purpose.

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